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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. [redacted] 75-1299

SHELL OIL COMPANY, ET AL.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

CONDITIONAL CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. A-551

SHELL OIL COMPANY, ET AL.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

CONDITIONAL CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Shell Oil Company, *et al.* (hereinafter referred to as "Producers") conditionally cross-petition for a writ of certiorari to review the Judgment of the United States Court of Appeals for the Fifth Circuit entered in this case on October 14, 1975, in the event petitions for a writ of certiorari filed by other parties below are granted by this Court.

OPINIONS BELOW

The Opinion of the Court of Appeals is reported at 520 F.2d 1061, *et seq.*, and its Opinion On Petitions for

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Rehearing issued January 14, 1976 is reported at 525 F.2d 1261, which Opinions appear in the Chevron Appendix, pp. A-1 to A-45; B-1.[1] The Opinion of the Federal Power Commission, Opinion No. 699 is reported at 51 F.P.C. 2212, *et seq.* and appears in the Chevron Appendix, pp. C-1 to C-282. Opinion No. 699-H of the Federal Power Commission on rehearing is not yet reported but appears at pages D-1 to D-158 of the Chevron Appendix.

JURISDICTION

The Judgment of the Court of Appeals was entered on October 14, 1975, and was clarified by an Opinion Denying Petitions on Rehearing entered on January 14, 1976. We invoke the jurisdiction of this Court under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717(r)(b) (C.A., pp. E-1 to E-10).

QUESTIONS PRESENTED

In light of the Opinions and Judgment below, and the pending proceeding before the Federal Power Commission entitled "National Rates For Jurisdictional Sales Of Natural Gas Dedicated To Interstate Commerce On Or After January 1, 1973", for the period January 1, 1975 to December 31, 1976, Docket No. RM75-14, Producers deem petitions for writs of certiorari in this case premature, and questions raised thereby not yet ripe for review by this Court, except for the Petition filed by Chevron Oil Company on Question No. 2 below, which goes to the juris-

1. Simultaneously herewith, Petitioner The California Company, A Division of Chevron Oil Company, is filing in No. _____, Appendices to their Petition for Writ of Certiorari containing the opinions below, the agency opinions, and statutes involved. Reference to the "Chevron Appendix' or "C.A." are to that document.

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diction of the Federal Power Commission. However, if this Court concludes otherwise and grants petitions filed by other parties, the following questions necessarily are also presented:

1. Whether the Commission is required by the Natural Gas Act, and Court decisions under that Act, to determine the ceiling price for new gas within the range of cost estimates contained in the record, or whether in the alternative, the Act and Court decisions require the Commission to consider the end result of its Orders on the supply of natural gas in the United States, and on the ability of interstate pipelines to compete for available new gas supplies, and if the Commission finds upon such consideration that the cost-based rate will not elicit adequate gas supplies and will not permit interstate pipeline companies to compete for available supplies must the Commission then adjust the rate upward accordingly?

2. Whether the Commission committed error in issuing a retroactive rate order requiring producers to waive certain rights which the Commission had granted in earlier opinions and which had been finally affirmed after Court review, in order to avail themselves of the rates which the Commission now finds to be just and reasonable for new gas?

3. Whether the Commission has understated the range of cost estimates utilized by it in establishing the national ceiling rate through its failure to make proper adjustments for the decline in productivity of drilling and the increase in various cost components which occurred subsequent to the filing of the data utilized by the Commission Staff in making the

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cost estimates, including specifically increases in lease acquisition costs and federal income taxes?

STATEMENT OF FACTS

On April 11, 1973 the Commission issued a Notice of Proposed Rulemaking in Docket No. R-389-B to determine a national rate applicable to sales of "new" gas, as defined in its Order.

Comments of interested parties were filed in May of 1973, containing voluminous cost and non-cost evidence. Replies to those Comments were filed in June of 1973. On March 21, 1974, the Commission issued a second Notice, attaching a revised Staff nationwide cost study and a Staff study of American Gas Association reserve additions. Following this study a conference was held by the Commission on April 16, 1974. Comments were then again filed on May 7, 1974, directed primarily to the Staff's studies, and replies filed on May 28, 1974. Again, the Producers' Comments, and those of some of the other parties, contained extensive testimony dealing with cost and non-cost issues.

On June 21 1974 the Commission issued Opinion No. 699 (C.A., pp. C-1 to C-282) prescribing a single uniform national base rate of 43 cents per Mcf. The base ceiling rate was subject to adjustment upward and downward for Btu content, and was adjusted upward for gathering performed by producers, and for state or federal production, severance or similar taxes. The Commission made extensive findings with reference to the natural gas shortage, and stated the following:

> "[O]ne of the primary goals which we have in establishing a national rate is to set a rate sufficient to

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> encourage the exploratory and developmental drilling which is required to discover and produce the natural gas supplies necessary to attain an objective of self-sufficiency in natural gas supplies available for delivery to the ultimate consumer." (C.A., p. C-20)

The Commission further found that the pervasive gas shortage "requires that this Commission promulgate producer pricing policies which will attract long-term dedications of new natural gas supplies to the interstate market." The Commission made extensive findings that the gas well exploratory and developmental drilling was inadequate (C.A., p. C-26), that additional gas discoveries were required (C.A., pp. C-26, 27) that massive capital commitments would be called for to finance these programs (C.A., p. C-28), and that it had the regulatory obligation to establish a uniform national rate to provide incentives to stimulate exploration and development (C.A., pp. C-28, 29). The Commission found that there was no reliable method to accurately quantify the amount of additional supplies attributed to price increases; however, it recognized that when the drilling trends were compared with price trends it was apparent that the increase in the price at which the natural gas could be sold in the interstate market would bring forth new suppplies of natural gas for dedication to that market (C.A., p. C-35). The Commission then discussed the curtailment programs of the various pipeline companies, and found that:

> "[T]he nation is still and will continue to be confronted with the national energy emergency resulting from a shortage of basic fuels required to maintain a productive economy." (C.A., p. C-40)

Nevertheless, after making all of these findings with reference to gas supply and the price supply relationship,

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the Commission proceeded to base its national ceiling rate entirely on cost evidence in the record (C.A., p. C-130).

The Commission found a cost range of 37.54 to 42.74 cents[2] and fixed the national ceiling rate at the upper end of that range, however, the Commission conceded that the cost estimates were imprecise (C.A., p. C-128) and that the rates so determined would not have the effect of dampening demand for natural gas, as the price it fixed was still much less than the price of substitutable fuels (C.A., pp. C-129, 130; pp. C-42, 43). The Commission concluded that court decisions, primarily the *City of Detroit Case*,[3] did not permit it to exceed that cost range, even though the evidence showed that intrastate market prices onshore were substantially higher and that interstate pipelines could not compete for new gas supplies onshore because of the Commission's ceiling. The record demonstrated that the Department of Interior was rejecting bids for gas-prone leases in the offshore Federal Domain unless the bidder based his bid on an estimate for the gas price in excess of the Commission's ceiling rate. The evidence also showed that the commodity value of natural gas was substantially higher than the ceiling rate, and that the capital requirements of the industry exceeded the revenue which would be derived from those rates.

Commissioners Brooke and Moody dissented on the grounds that the majority of the Commission had not made the "pragmatic adjustments" in the ceiling rate indicated

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2. On rehearing, the Commission redetermined the cost range to be from 47.82 cents to 51.46 cents (C.A., p. D-36).

3. *City of Detroit v. F.P.C.*, 230 F.2d 810 (D.C. Cir. 1956), cert. denied, 352 U.S. 829 (1956).

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by its supply and demand findings. In the words of Commissioner Brooke, the non-cost adjustments were "woefully lacking".

Extensive Applications for Rehearing were filed and the Commission held oral argument on August 22 and 23, 1974. Pipelines, distribution companies, consumers, and producers attacked the Commission ceiling rate as being too low, stating that interstate pipeline companies could not compete for available new gas supplies onshore at that level and that the Commission's ceiling price would severely retard offshore development for new non-associated gas supplies.

On December 4, 1974 the Commission issued Opinion No. 699-H (C.A., pp. D-1 to D-158), revising upward the national ceiling rate for new gas to 50 cents, with an additional one-cent increase effective January 1, 1975, also based entirely on a revision in its cost estimates, to a range of 47.82 cents to 51.46 cents. In addition to the base ceiling rate, the Commission allowed the ceiling rate to be increased by the amount of state or federal severance or production taxes, or similar taxes, by an upward or downward Btu adjustment from a base of 1,000 Btu per cubic foot, and by gathering increments varying between production areas. Petitions for Review were filed in the Court of Appeals for the Fifth Circuit.

On the same day that the Commission denied rehearing in this case in Opinion No. 699-H, it issued an Order in a new docket, Docket No. RM75-14, which undertakes a complete review of all of the rate ceilings decided in Opinion Nos. 699 and 699-H. The requirement for waiver of the refund work-off provision is not being reconsidered in Docket No. RM75-14. Voluminous Comments and

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Reply Comments have been filed in this proceeding, and the proceeding is now pending, awaiting Commission decision.

In its Opinion issued October 14, 1975, 520 F.2d 1061, the Court of Appeals affirmed the Commission in all respects (C.A., pp.A-1toA-45). The Court of Appeals relied, on a number of specific issues, on the fact that the Commission was currently reconsidering these issues in the Biennial Review Case, Docket No. RM75-14, *supra*. In particular, the Court of Appeals held that the challenge raised by Producers that the Commission had not properly considered the end result of its rate structure, and had not properly considered the repeal of the depletion allowance on the Federal income tax allowed in producer rates, was premature, and would be reconsidered by the Commission in the Biennial Review Proceeding.

REASONS FOR GRANTING THE WRIT

I.

The Commission's Decision Below Is Based On An Error Of Law Which Will Be Repeated In Its Subsequent Opinion Unless Otherwise Directed By This Court.

In the case below, the Commission found that it was constrained by Court decisions to limit its ceiling rate for producers to a range indicated by the cost estimates in the record. Even though the Commission made specific findings on supply, market conditions, capital requirements, commodity value, and other factors which establish the necessity for a higher ceiling rate, the majority of the

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Commission[4] held that it was prohibited by Court decisions from increasing the rate to the levels indicated by these economic factors.

Far from *requiring* the Commission to utilize cost in determining producer rates, as the Commission assumed (C.A., pp. C-127 to C-130), the Court has held that the Commission is *permitted* to utilize costs in determining producer rates, *provided* the "end result" is compatible with the public interest, see *Permian Basin Area Rate Cases*, 390 U.S. 747, 791, 796 (1968).

In the most recent producer rate case to be considered by this Court, *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974), this Court rejected an attack by some of the parties on the Commission's decision on the ground that it had no basis in costs. The Court stated:

> "Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in Permian Basin and we reject it again here. The Commission explicitly based its additional 'non-cost' incentives on the evidence of a need for increased supplies. Obviously a price sufficient to maintain a producer, while not itself necessarily required by the Act (n. omitted), may not be sufficient also to encourage an increase in production." (417 U.S. at 316, 317, 41 L.Ed2d at 99-100)

Despite the clear language of *Permian* and *Mobil*, the Commission concluded that it would be committing legal

4. Two of the five Commissioners dissented on this question (C.A., pp. C-167 to C-170).

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error if it established a ceiling rate which exceeded the range of the cost estimates in the record. This conclusion was reached despite its further findings that prices in the intrastate market were substantially in excess of the Commission's ceiling rate, and that interstate pipelines would be unable to purchase gas in competition with that market at the ceiling rate prescribed by the Commission (C.A., pp. C-129; C-218 to C-220; C-225).[5]

The record is clear that the impact of utilizing an average nationwide unit cost to form a nationwide ceiling rate is to confine exploration and development to the most favorable prospects which can be developed at costs which are below the average level, and exclude all projects believed to cost in excess of that level. The inevitable result, as noted in the dissenting opinion (C.A., p. D-145), is not a ceiling on profits but a decline in exploration, with a subsequent decline in long-term supply and an increasing gas shortage in the United States. As the Fifth Circuit notes:

> ". . . [T]he effort to protect the consumer interest as to price is at odds with the long range consumer interest in maintaining an adequate supply of natural gas for the interstate market." (C.A., p. A-18)

The Fifth Circuit lamented the "failure of the Commission to assess the consequences of its various policies" but finally concluded that the cost-based rate was experimental and that it was premature to find that it did not meet the end result test (C.A., p. A-45). Thus, the Commission is

5. See also FPC Bureau of Natural Gas Staff Report issued November 1975, showing average price for non-jurisdictional sales of natural gas for period January through June 1975 to be $1.259 per Mcf.

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left undisturbed in its belief that it is required by the Court decisions to confine its ceiling rate to the range of cost studies in the record, even though it also finds that such a rate will prevent exploration, increase the gas shortage, and prevent adequate development of our natural resources. In the absence of a contrary decision by this Court, or a change in the Natural Gas Act by Congress, such a result becomes inevitable.

II.

The Commission's Requirement For A "Waiver" Of The Refund Credit Provision Amounts To A "Retroactive Rate Order" Prohibited By Law.

In four of its area rate decisions,[6] after fixing certain price levels as "refund floors" and requiring refunds of all amounts collected above those levels, the Commission provided that the refunds so ordered could be discharged through the dedication of additional gas reserves subsequently found in those areas at the rate of one cent per Mcf for each Mcf of new reserves discovered and dedicated to the interstate market. One of the reasons given by the Commission for this provision was to leave the

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6. *Texas Gulf Coast Area Rate Case*, 45 F.P.C. 674, 18 C.F.R. § 154.109; reversed and remanded, *Public Service Commission of New York v. F.P.C.*, 487 F.2d 1043 (D.C. Cir. 1973), vacated and remanded, *sub nom. Shell Oil Co. v. Public Service Commission of New York*, 417 U.S. 964 (1974), affirmed on remand, 516 F.2d 746 (D.C. Cir. 1975); *Southern Louisiana Area Rate Case*, 46 F.P.C. 86, 18 C.F.R. § 154.105; affirmed, *Placid Oil Co. v. F.P.C.*, 483 F.2d 880 (1973), affirmed, *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974), *Other Southwest Area Rate Case*, 47 F.P.C. 99, 18 C.F.R. § 154.109 (a); affirmed, *Shell Oil Co. v. F.P.C.*, 484 F.2d 469 (5th Cir. 1973), cert. denied *sub nom. Mobil Oil Corp. v. F.P.C.*, 417 U.S. 973 (1974); and *Permian Basin Area Rate Case II*, 50 F.P.C. 313.

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capital represented by these refunds in the hands of the producers to encourage additional exploration, and tie that exploration specifically to the pipelines served in that area (45 F.P.C. at 711). This provision of the Commission's Opinions was extensively challenged by the Public Service Commission of New York and Mobil Oil Corporation, and was affirmed by the Fifth Circuit in two separate opinions, *Placid Oil Co. v. F.P.C.*, 483 F.2d 880 (1973) and *Shell Oil Co. v. F.P.C.*, 484 F.2d 469 (1973). It was one of the issues raised on certiorari from the *Placid* case by Mobil, New York and MDG, and discussed extensively in this Court's Opinion in *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974), 41 L.Ed.2d 72, at 104-05. A contrary ruling by the District of Columbia Circuit in *Public Service Commission of New York v. F.P.C.*, 487 F.2d 1043 (1973) was vacated and remanded by this Court in *Shell Oil Co. v. Public Service Commission of New York*, 417 U.S. 964 (1974), and on remand the D.C. Circuit affirmed the Commission's Opinion, 516 F.2d 746 (1975).

Less than two weeks after this Court's decision in *Mobil, supra* (decided June 10, 1974), the Commission issued Opinion No. 699 here under review (June 21, 1974), wherein the Commission held that nationwide just and reasonable rate for all gas contracted for after January 1, 1973[7] was 42 cents per Mcf (increased by Opinion No. 699-H to 50 cents per Mcf). But then the Commission determined that some producers would not be entitled to collect the rate found to be just and reasonable for some or all of their new natural gas. The Commission decided (C.A., pp. C-109 to C-111; C-115, 116) that producers who elected to work-off their existing refund obligations,

7. And the categories noted in the Commission's Opinion see C.A., p. .

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as they were given the right to do in the four area rate decisions above cited, could not receive the just and reasonable rate for the gas so utilized, even though in all other respects it met the requirements to be classified as "new" natural gas.

Recognizing the questionable nature of an order which would deprive producers of a right just sustained by this Court only eleven (11) days earlier, the Commission sought to circumvent this problem by requiring the producer to "waive" his rights under the earlier area rate decisions in order to take advantage of the new nationwide ceiling rate (C.A., p. C-115). In so doing the Commission made a pretense of "substituting incentives" in requiring the producer to choose between the refund credit already given in the prior decisions and the rate which the Commission now found to be just and reasonable for the reserves currently being discovered. Yet, if the Commission's determinations of law were correct, the producers now are not required to choose, but have the right, which this Court has sustained, to receive the refund credit under the earlier decisions, and have the further right to receive whatever the Commission determines to be the just and reasonable rate for the new gas which they discover.

The Commission has overlooked the vital time factor involved in the two decisions. The earlier area rate decisions dealt with the just and reasonable rate levels for gas sold prior to the date of those decisions. The Commission's decision below makes no attempt to change those levels or refund floors. To do so would have been a retroactive rate order of the type prohibited by this Court's decision in *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 618 (1944). Similarly, the Commission committed error by retroactively changing the *manner* in which those

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refunds were to be discharged, *i.e.*, the dedication of new gas reserves instead of repayment of the money in cash.

The Court of Appeals sustained the Commission, saying that it was within the Commission's discretion to determine an alternative rate system substituting one incentive structure for another (C.A., pp. A-41, 42). In so holding however, the Court of Appeals also lost sight of the different *time* during which the respective structures apply. The rate structure in the area rate decisions applied for all time periods prior to those decisions, and up until June 21, 1974, the effective date of the Commission's Opinion here under review. The Commission acknowledges that reserves dedicated prior to that date will still receive the refund credit, provided those reserves did not receive the national ceiling rate for new gas.

What the Commission and the Court of Appeals failed to recognize, is that there was never any connection between the price received for the new reserves to be dedicated, and the fact that those reserves could be credited against the refund provision. The earlier decisions clearly contemplated the sale of those reserves at whatever the applicable just and reasonable rate was at the time the reserves were dedicated. In this respect, this case is clearly distinguishable from *Moss v. F.P.C.*, 502 F.2d 461 (D.C. Cir. 1974), relied upon by the Commission and the Court of Appeals. In the *Moss* case, the Commission set out an "optional" procedure which the producer could elect to follow or not. If he elected to follow the *optional* procedure, he was entitled to receive a rate higher than the current just and reasonable rate, in return for a waiver of other rights. In the case below, the producer was given no option to choose between a just and reasonable rate or a higher rate. On the contrary, the Opinion below unlaw-

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fully deprives the producer of the just and reasonable rate unless he agrees to waive rights vested by another Commission opinion.

III.

The Commission's Cost Estimate Which Is the Sole Basis Of Its Ceiling Rate, Is Defective.

This Court in *Permian* approved the Commission's discretion to select various relevant costing components in arriving at a cost estimate. There are however, several errors in the Commission's costing estimate which are so patent and obvious that the failure to correct these errors must inevitably arrive at a costing result which will fail to return to the entire producing industry even its national average costs. We will point out only three of these costing errors, which have the most substantial impact. In so doing, we emphasize the Commission's own findings that its cost estimates are not "precise" (C.A., p. C-47) and that the Commission has only attempted to establish a "permissible zone of deviation" for costs (*Id.*). The uncertain nature of these costing studies re-emphasizes our first point, *supra*—that the Commission must be instructed that it is not confined to such cost studies in arriving at the just and reasonable rate for producers.

A. The Commission Has Failed To Recognize And Allow For The Trend In Declining Productivity.

In the language of the Court of Appeals:

> "One of the most important and hard to predict variables in the cost-based formula is productivity,

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> the amount of natural gas that will be added to non-associated gas reserves for every foot drilled resulting in some addition to those reserves." (C.A., p. A-31)

The dissenting opinion below notes:

> "If we err in predicting productivity, we destroy the integrity of the whole rate structure." (C.A., p. C-179)

In the decision below and prior decisions, the Commission has recognized those phenomena which are peculiar to the oil and natural gas producing industries. These phenomena have two aspects:

> (a) The number of gas reservoirs located in the Continental United States is finite. Exploration in search of those reservoirs throughout over the 100-year history of this industry has resulted in the discovery of the most accessible, and therefore lower cost, of these reservoirs, with the result that those remaining to be found must be discovered in areas of increasing difficulty, such as greater depths, offshore water locations, etc. It also means that the largest reservoirs have probably already been found, and that those remaining to be found will be smaller in volume, so that future wells (although more expensive) will have less "productivity" than wells drilled to more prolific reservoirs in the past.
>
> (b) Each producer has a catalog of "prospects" which he hopes may be productive of gas, but whose productivity, if any, cannot be ascertained without large capital expenditures. One of the factors in the calculus involved in the decision of whether these expenditures will be made, is the question of the revenue to be received from the product, if any, to

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be produced from the reservoir. As the price per unit of the product increases, the size of the reservoir which needs to be discovered in order to return the exploration and development costs is reduced. Thus, contrary to the situation in all other industries regulated as utilities, the *price* permitted by the Commission *determines* the *cost* which will be incurred by the producer in the attempt to find reservoirs which he can sell at the predetermined price. This factor has its impact upon "productivity" as the higher the price, the lower the "productivity" which can be accepted by the producer in making the expenditure.

These two inherent characteristics of the producing industry are recognized in the Opinion below (C.A., pp. C-64, 65) and in prior proceedings, *e.g., Texas Gulf Coast Area Rate Proceeding,* 45 F.P.C. 674, 703 (1971).[8] Yet while accepting the theoretical validity of these characteristics, the Commission refuses to consider them in its determination of a productivity number which is one of the most important inputs in the costing formula. The Commission utilized an average productivity of a seven-year year period from 1966 through 1972 and arrived at a productivity of 485 Mcf per foot (C.A., p. C-261) Adding the additional year of 1973, which was not available to the Commission at the time the initial Opinion No. 699 was issued in June of 1974, but was available prior to the time the Opinion on rehearing was issued in December of 1974, the data series reads as follows:

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8. Reversed, *Public Service Commission of New York v. F.P.C.*, 487 F.2d 1043 (D.C. Cir. 1973), vacated and remanded, *sub nom. Shell Oil Co. v. Public Service Commission of New York*, 417 U.S. 964 (1974), affirmed on remand, 516 F.2d 746 (D.C. Cir. 1975).

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	Mcf/ft.	Mcf/ft.
1966	630	660
1967	806	830
1968	614	610
1969	318	290
1970	472	410
1971	427	380
1972	286	280
1973	113	104

Those data available to the Commission show an unmistakable downward trend in productivity, which is to be expected if the Commission's theoretical premises, as noted above, are accurate. By utilizing an average of the seven-year period to project into the future, even for the year 1973 where data shows affirmatively to be substantially less than the projection, the Commission ignored the downward trend of productivity in establishing its cost-based ceiling. The impact of this error was substantial. If the Commission had simply used the seven-year average, including the year 1973 instead of the outdated year 1966, the average productivity for that period would have been 433 Mcf/ft., and its cost calculation would have increased by 14 cents per Mcf.

B. The Commission's Formula Grossly Understates Lease Acquisition Costs As Shown By The Record.

The Commission's method has been to estimate lease acquisition costs by deriving a ratio between such costs and the statistical average of national successful well costs. The time period utilized by the Commission in this case is the five-year period 1967 through 1972. Under this method, lease acquisition costs were estimated by the Commission to be 67 percent of successful well costs.

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In the years since 1972, this percentage has been completely distorted by the large expenditures required for bidding for leases in the Outer Continental Shelf owned by the Federal Government. The trend is apparent from the total bonus bids on Outer Continental Shelf lease sales shown in Appendix A, which shows the lease sales from 1954 through 1974. A dramatic increase occurred in 1972, which is not reflected by the Commission's method. The correction of this error alone would result in an increase in the national ceiling rate of approximately 25 cents per Mcf.

C. However The Commission Computes The Costs, It Erred In Failing To Include A Component, Or Allowance, For Federal Income Tax Liability.

Although the Commission historically has adopted, and this Court has approved, an area average cost methodology for determining the rates producers who sell gas in interstate commerce are allowed to charge for such sales, with respect to federal income tax cost component the Commission dramatically has departed from the procedure for determining costs used with respect to all other elements of cost. Instead, the Commission has stated, contrary to *all* record evidence, that the only way it would allow any producer to recover the liability for federal income tax is for such producer to file a special, separate pleading, *annually,* asking for special relief from the Commission's established rate merely to recover its federal tax costs. This position of the Commission is wholly at odds with the nationwide *average* cost approach it espouses with respect to all other cost factors.

Further, as a condition to recovery of federal income taxes incurred on the sale of an Mcf of gas in interstate

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commerce, the Commission requires the producer to file his actual federal income tax return (C.A., pp. C-117, 118). This concept is so totally out of touch with reality as to be meaningless. The federal income tax paid in any one taxable year bears, and can bear, no relation to any producer's tax on interstate natural gas revenues. The reason for this is simple: natural gas producers file only one federal income tax return which, by law, relates to tax liability on income from many sources including natural gas sold in interstate commerce, not covered by the nationwide ceiling rate set by the Commission. The Commission's Order requires the producer of gas to segregate its revenues, deductions, and tax liability allocable to the category of gas to which the ceiling rate applies, from the deductions and tax liability attributable to all income.

As if these practical problems were not sufficient to make the Commission's approach to recovery of taxes unworkable, the Commission's Order also fails to take into account that revenues under its rate will not, and indeed cannot, be correlated to a tax year or to expenses which qualify for deductions in a tax year.

In a more recent decision in the Nationwide Rate For Flowing Gas Case, Docket No. R-478, issued December 31, 1975, the Commission included a component for federal income tax in the cost calculation for flowing gas. While the Court of Appeals' Opinion below leaves the Commission free to follow a similar procedure in the Biennial Review Case, Docket No. RM75-14, this error remains uncorrected in the Opinion here under review.

The Commission's method for recovery of federal income tax liability in Opinion Nos. 699 and 699-H will

not, and cannot, provide a producer the ability to recover the federal income tax liability incurred on the sale of natural gas in interstate commerce.

CONCLUSION

The Commission is now engaged in a comprehensive review of the ceiling rates established in the Opinion below. We therefore believe that this Court's consideration of those rates at this time is premature, and the Commission should be left to complete its task. If, however, this Court decides to grant any petition for certiorari from the Commission's Opinion, the questions raised herein should also be considered by the Court.

Respectfully submitted,

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APPENDIX A

OUTER CONTINENTAL SHELF LEASE SALES
Through 1974

Date		State	Acres Offered	Acres Leased	Total Bonus
10-13-54		Louisiana	748,000	394,721	$ 116,378,476
11- 9-54		Texas	111,788	67,149	23,357,029
7-12-55		Texas	216,000	149,760	8,437,462
7-12-55		Louisiana	458,095	252,807	100,091,263
2-26-59		Florida	458,000	132,480	1,711,872
8-11-59	*	Louisiana	81,813	38,820	88,035,121
2-26-60		Texas	437,760	240,480	35,732,031
2-26-60		Louisiana	1,173,223	464,046	246,909,784
3-13-62		Louisiana	1,808,276	951,811	177,260,305
3-16-62	*	Texas	90,720	28,800	557,720
3-16-62		Louisiana	1,780,265	927,746	267,775,727
10- 9-62	*	Louisiana	33,855	16,178	43,887,359
5-14-63		California	669,777	312,945	12,807,587
4-28-64	*	Louisiana	34,028	32,673	60,340,626
10- 1-64		Oregon	836,134	425,433	27,768,772
10- 1-64		Washington	253,940	155,420	7,764,928
3-29-66	*	Louisiana	35,993	35,056	88,845,963
10-18-66	*	Louisiana	227,898	104,717	99,164,930
12-15-66	*	California	1,995	1,995	21,189,000
6-13-67		Louisiana	971,489	744,456	510,079,178
2- 6-68		California	540,609	363,181	602,719,262
5-21-68		Texas	728,551	541,304	593,899,046
11-19-68	*	Louisiana	46,824	29,682	149,868,789
1-14-69	*	Louisiana	96,389	48,505	44,037,339
12-16-69	*	Louisiana	93,764	60,153	66,908,196
7-21-70	*	Louisiana	73,360	44,642	97,769,013
12-15-70		Louisiana	593,485	546,398	845,877,860
11- 4-71	*	Louisiana	55,872	37,222	96,304,522
9-12-72		Louisiana	366,682	290,321	585,827,925
12-19-72		Louisiana	604,029	535,874	1,665,519,631
6-19-73		Texas	697,643	547,173	1,591,397,380
12-20-73		Alabama, Florida & Mississippi	817,397	497,108	1,491,617,119
3-28-74		Louisiana	930,918	421,218	2,092,510,854
5-29-74		Texas	1,355,678	565,112	1,471,851,831
7-30-74		Texas & Louisiana	1,298,739	100,241	30,236,800
10-16-74		Louisiana	1,421,546	675,587	1,428,261,330
TOTALS			20,150,535	10,781,214	14,792,702,030

* Drainage sale

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Supreme Court, U. S.
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MICHAEL RODAK, JR., CLERK

Nos. 75-1289, 75-1299, 75-1304, 75-1305, 75-1308

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

THE CALIFORNIA COMPANY, A DIVISION OF CHEVRON OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL POWER COMMISSION, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF RESPONDENT MOBIL OIL CORPORATION IN OPPOSITION TO PETITIONS

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WILSON - EPES PRINTING CO., INC. - RE 7-6002 - WASHINGTON, D. C. 20001

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

Nos. 75-1289, 75-1299, 75-1304,
75-1305, and 75-1308

THE CALIFORNIA COMPANY, A DIVISION
OF CHEVRON OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL POWER COMMISSION, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF OF RESPONDENT MOBIL OIL CORPORATION IN OPPOSITION TO PETITIONS

Mobil Oil Corporation, an intervenor in support of the respondent Federal Power Commission below and a respondent here, submits this brief in opposition to petitions for writs of certiorari to review the judgment entered in this case on October 14, 1975 by the United States Court of Appeals for the Fifth Circuit.

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 520 F.2d 1061 (Calco App. A),[1] and the Court of Appeals opinion denying rehearing is reported at 525 F.2d 1261 (Calco App. B). Federal Power Commission Opinion No. 699 is reported at 51 F.P.C. 2212 (Calco App. C); Federal Power Commission Opinion No. 699-H is not yet reported (Calco App. D).

JURISDICTION

Petitioners properly invoke the jurisdiction of this Court under 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

QUESTIONS PRESENTED

Mobil opposes all petitions seeking review of the judgment of the Court of Appeals, supports the position of the respondent Federal Power Commission, and limits this brief to the following questions:[2]

---

[1] References are to the separate Appendix to the Petition of The California Company (Calco) filed in No. 75-1289.

[2] In No. 75-1299, Shell Oil Company, *et al.*, seek review of other questions concerning Commission choices of methodology and findings as to costs which the Court of Appeals held to be within the Commission's authority and discretion and supported by substantial evidence (Shell Pet., pp. 3-4, questions 1 and 3).

In No. 75-1304, American Public Gas Association similarly seeks review of Commission choices of methodology, use of data, and decisions as to costs, which were upheld below on similar grounds (APGA Pet., pp. 2-3, question 2).

In No. 75-1304, American Public Gas Association also seeks review of questions of procedure not actually presented in this case (APGA Pet., p. 2, question 1). In this instance, the Commission proceeded on the basis of successive public notices, sworn comments, data and pleadings, reply comments and pleadings, a public conference on specific issues, applications for rehearing, and oral argument (see Calco App. C-3 - C-18, App. D-4 - D-14). These procedures

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1. Whether the Federal Power Commission properly determined that rates prescribed as "just and reasonable" under Sections 4 and 5 of the Natural Gas Act for "new gas," as defined by the Commission, should be applied to natural gas sold by a producer under a new gas sales contract negotiated by the producer and a pipeline purchaser to replace an earlier long-term contract which has expired by its own terms.

2. Whether the Federal Power Commission reasonably found and concluded that (1) natural gas sold at rates established for "new gas" could not be applied to reduce individual producers' refund liabilities and to earn contingent rate escalations as prescribed and permitted by the Commission's earlier area rate decisions; and (b) individual producers should be afforded the option of selling at the new rates or of continuing to sell at area rates and to earn refund credits and rate escalations permitted by the area rate decisions.

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more than met the "minimal requirements" for "rulemaking" to prescribe rates under the Administrative Procedure Act, 5 U.S.C. § 553 and § 556(d), and the "hearing" requirements of Sections 4 and 5 of the Natural Gas Act where there is no genuine issue of disputed material facts (see Calco App. A-23 - A-22). The decision below thus presents no conflict with constructions of the APA and the Natural Gas Act by the Court of Appeals for the District of Columbia Circuit in *Mobil Oil Corporation* v. *FPC*, 483 F.2d 1238 (1973), and is consistent with other decisions of that court holding that where there is no such genuine issue of material fact, neither the APA nor the Natural Gas Act requires formal "adjudicatory" hearings. See *Pennsylvania Gas and Water Co.* v. *FPC*, 463 F.2d 1242, 1245 (D.C. Cir. 1972); *City of Chicago* v. *FPC*, 458 F.2d 731 (D.C. Cir. 1971), *cert. den.*, 405 U.S. 1074 (1972); *Municipal Light Boards of Reading and Wakefield, Mass.* v. *FPC*, 450 F.2d 1341, 1345 (D.C. Cir. 1971); *American Public Gas Association* v. *FPC*, 498 F.2d 718 (D.C. Cir. 1974). Procedures used by the Commission thus represent a permissible middle-ground between "minimal requirements" for "informal rulemaking" under the APA and adjudicatory-type hearings.

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STATUTES INVOLVED

Sections 4, 5, and 7 of the Natural Gas Act, 15 U.S.C. §§ 717c, d, and f, are involved and are set forth in Appendix E to the Petition in No. 75-1289.

STATEMENT

Mobil is an independent producer of natural gas and makes substantial sales in most of the production areas of the United States subject to Commission jurisdiction under the Natural Gas Act. Mobil participated in all proceedings before the Commission in this case and supported the Commission below in seeking affirmance of Commission Opinion Nos. 699 and 699-H. Procedural history pertinent to questions presented is:

1. On December 12, 1972, in its Opinion No. 639, the Commission announced its intention to phase out the so-called "two-tier" pricing or "vintaging" system initiated on an experimental basis in 1960, and to allow natural gas producers to receive the higher "new gas" rate where (1) a gas sales contract expires by its own terms, (2) the producer and the pipeline purchaser negotiate a new long-term contract permitting the higher rate, and (3) the new contract is filed with the Commission as part of an effective rate schedule under Section 4 of the Act. *Area Rates for Appalachian and Illinois Basin Areas*, 48 F.P.C. 1299, reh. denied, 49 FPC 361 (1973).[3]

By notice issued on April 11, 1973 in Docket No. R-389-B, the Commission initiated this case to determine a new uniform national rate for sales of natural gas produced from wells commenced on or after January

[3] This decision was affirmed in *Shell Oil Company* v. *FPC*, 491 F.2d 82 (5th Cir. 1974). Application of the decision to specific contracts and producer rate filings was affirmed in *Public Service Commission for the State of New York* v. *FPC*, —— F.2d —— (D.C. Cir. Nos. 73-1647, *et al.*, decided January 27, 1976).

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1, 1973 (R. 79, 80). In comments filed on May 16, 1973 and during 1974, respondents urged the Commission to apply the policy announced in Opinion No. 639 and permit application of the new rate to new contracts executed on or after January 1, 1973 to replace expired and expiring contracts. Reasons advanced were that such action would be consistent with Commission intent expressed in Opinion No. 639; the new price would encourage recompletions, reworking operations, and installation and maintenance of compression facilities; and the new price would prevent premature abandonment of existing reservoirs (R. 893).

In Opinion No. 699, issued June 21, 1974, the Commission considered the question and concluded that the new rate should apply to ". . . sales made pursuant to contracts executed on or after January 1, 1973, where the sales were formerly made pursuant to permanent certificates of unlimited duration under contracts which expired by their own terms on and after January 1, 1973, in accordance with Opinion No. 639 . . ." (Calco App. C-2, C-107). The Commission supported this conclusion by reference to the need for additional revenues for expanded exploration and development programs, to offset of claimed attrition in the rate of return reflected in discounted cash flow studies, and to its purposes of encouraging new dedications to the interstate market "whether such new supplies come from new acreage dedications, or from newly drilled wells, or by diversion from other uses" (Calco App. C-108).

Various parties sought rehearing; oral argument followed; and on December 4, 1974, the Commission issued its Opinion No. 699-H, adhering to its decision on this question (Calco App. D-1, D-43 - D-47). In that opinion, the Commission found that claims for a higher rate of return were offset, in part, by the additional revenues to be available under renewal contracts qualifying for the

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national rate (Calco App. D-34); adhered to its views that eligibility was limited to contracts replacing a contract expiring by its own terms and to situations in which the producer and pipeline purchaser executed a new contract; and stated:

> "In many cases, the purchasing pipeline may desire a *quid pro quo* from the selling producer in the form of additional acreage dedication, exploration and development activity on the previously dedicated acreage, or other similar activities that could result in the dedication of additional new gas supplies to the interstate market. Such concessions by the seller certainly will not be made if the price is allowed to increase to the national rate automatically without the requirement of a renewal contract." (Calco App. D-45 - D-46)

In addition, the Commission found that much of the capital required for exploration, development, and production must come from "gas production revenues" (Calco App. D-55), and that the principles adopted would provide additional revenues, as contracts were renewed, and additional capital for exploration and development of "new natural gas supplies for the interstate market" (Calco App. D-55). The Commission also included estimates of such additional revenues in its assessment of impact of its decision upon the industry and consumers (Calco App. D-57).

Commission Opinion No. 699-H thus provides that the new rate applies to sales under new contracts executed on or after January 1, 1973 replacing contracts covering sales made under permanent certificates of unlimited duration which expired by their own terms either prior to or after January 1, 1973 (Calco App. D-78).

On review, the Commission's findings and conclusions were challenged, but the Court of Appeals affirmed (Calco App. A-1, A-27). First, the court found that

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there was adequate notice and a fair opportunity to be heard on the "renewal contract issue" before the Commission (Calco App. A-27). Second, the court found that the Commission had applied the new rate "functionally" with the objective of helping to "alleviate the current severe shortage"; that by requiring the prerequisite of a new contract, the Commission believed the purchaser "might be able to negotiate for additional acreage dedication to interstate commerce, or exploration and development activity on previously dedicated acreage or other concessions for the price increase"; and that the conflicting challenges buttressed the court's "deferral to the reasoned expertise of the Commission" (Calco App. A-29). The court held:

> "The FPC has reached a well-considered, expert decision on this issue. The Commission found from evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds. Additionally, it noted that by phasing out the vintaging practice and attending price variations, all consumers would more equitably bear the burden of financing added exploration." (Calco App. A-30)

The court further noted that the question would be examined in biennial review of the new national rates, and the Commission had struck "a tentative balance between the consumer and investor interests," which it was prepared to reevaluate, and concluded:

> "Under such a circumstance, no party has carried the heavy burden of showing that the Commission's balance is tilted so far in either direction as to be unjust and unreasonable in its consequence. We also consider the decision, although not compelled by the evidence, to be supported by the substantial evidence of a shortage and the need for a massive infusion of funds." (Calco App. A-30)

* * * *

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> "The Commission is not bound by its previous policies. As this Court and the Supreme Court have noted on various occasions, the rate structures which introduced or adjusted vintaging were experimental. It is necessary without a doubt that agencies be permitted latitude to evaluate old experiments and modify or abandon them when their best judgment requires such a course of action." (Calco App. A-31)

2. The Commission provided that the new national rate could not apply to sales of natural gas used to earn credits against individual producers' refund liabilities and escalations of rates permitted by its earlier area rate decisions.

In four area rate decisions, the Commission adopted a "package" rate structure, combining two tiers of rate levels, formulae for discharge of individual producer refund liabilities by dedication of new reserves to interstate purchasers, escalation of rates also tied to levels of new dedications, and moratoria on other rate increases for prescribed future years.[4]

In Opinion No. 699, the Commission determined that producers who elect to discharge their refund obligations by dedicating new supplies under these formulae, or to seek the contingent escalations by such dedications, must continue to price such natural gas at the area rates (Calco App. C-1, C-109 - C-110). The Commission concluded that such treatment was "equitable" and that:

---

[4] See *Placid Oil Company* v. *FPC*, 483 F.2d 880 (5th Cir. 1973), aff'd, *Mobil Oil Corporation* v. *FPC*, 417 U.S. 283 (1974); *Texas Gulf Coast Area Rate Case*, 45 FPC 674, ultimately aff'd on remand, *Public Service Commission for the State of New York* v. *FPC*, 516 F.2d 746 (D.C. Cir. 1975); *Other Southwest Area Rate Case*, 47 FPC 99, *aff'd*, *Shell Oil Company* v. *FPC*, 484 F.2d 469 (5th Cir. 1973), *cert. den.*, *Mobil Oil Corp.* v. *FPC*, 417 U.S. 973 (1974); *Permian Basin Area Rate Case II*, 50 FPC 390 (appeal withdrawn).

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> "To allow producers to collect the rate provided by this decision and to discharge their existing obligations and receive the benefits provided under the applicable area rate opinions with the same supplies of natural gas would be contrary to the spirit of the applicable area rate opinions. In essence, we seek to insure that a producer will not receive a double benefit from the rate structure which we establish in this decision." (Calco App. C-110, footnote omitted)

The Commission provided that individual producers must decide whether it is more beneficial to continue under the area rate formulae as to new sales or to obtain the national rate for such sales, and must file waivers as to the escalations and refund credits for sales the producer places under the national rate (Calco App. C-111).[5]

Producers who were beneficiaries of the refund-forgiveness formulae sought rehearing, but the Commission adhered to its conclusions in Opinion No. 699-H (Calco App. D-1, D-63). The Commission pointed out that the refund-forgiveness formulae were components of a total rate design in the area rate decisions, and that it was not reasonable to allow both those benefits and the new national rate for new sales (Calco App. D-64, D-65). In the Commission's view, allowance of both the new rate and the refund credits and contingent escalations allowed by the area rate decisions "would constitute an apostasy" of those opinions (Calco App. D-65).

The Court of Appeals affirmed the Commission, holding:

> "The new national rate is the product of an independent determination of incentives, and, as it is in

[5] For sales placed under the national rate under such an election, the Commission provided for lifting of moratoria on rate increases imposed by the earlier area rate decisions (Calco App. C-115).

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so many other regards, the new rate is not tied to previous determinations. Replacing one incentive structure with another or, viewed in another light, providing a new alternative rate system, is an exercise of Commission discretion which does not amount to retroactive rate regulation. See *Moss* v. *FPC*, 164 U.S. App. D.C. 1, 502 F.2d 461 (1974)." (Calco App. A-42)

ARGUMENT

None of the petitions presents questions requiring or warranting review by this Court:

I. The Court of Appeals Correctly Applied Standards And Principles of Review Required by the Natural Gas Act and Decisions of This Court

Petitioners assert that the judgment below is the result of erroneous application of standards of review under Section 19(b) of the Natural Gas Act and principles expressed by this Court. The assertions are incorrect.

In *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), this Court held that a "presumption of validity" attaches to exercise of the Commission's expertise, and that the functions of the Courts of Appeals under Section 19(b) were determinations of whether (1) the Commission had abused or exceeded its authority; (2) each of the essential elements of the Commission's rate order is supported by substantial evidence; and (3) the order may be expected "to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable" (390 U.S. at 791-792). The court's responsibility is not to "supplant" the Commission's balance of interests, but "to assure itself that the Commission has given reasoned consideration to each of the pertinent factors" (*Ibid*).

Thereafter, in *Mobil Oil Corporation* v. *FPC*, 417 U.S. 283 (1974), this Court held that application of these criteria is "primarily the task of the court of appeals"; responsibility "to assess the record to determine whether agency findings are supported by substantial evidence" is vested in the Court of Appeals by Section 19(b); and this Court will intervene "only in what ought to be the rare instance when the standard appears to have been grossly misapprehended or grossly misapplied" (417 U.S. at 309-310).

No such "rare instance" is presented. Controlling standards have been correctly apprehended and properly applied by the Court of Appeals. At the outset, the court noted, in express detail, "the *Permian* prescription" (Calco App. A-14 - A-19). The court then applied the criteria to each of the particulars of the Commission's order challenged below. Use of the "national rate" method was found within Commission authority (Calco App. A-20 - A-23); no error was found as to Commission procedures (Calco App. A-23 - A-27); specific cost findings, details of the rate structure, and Commission methods were found to be reasonable and supported by the record and substantial evidence (Calco App. A-27 - A-44); and the "end result" was sustained (Calco App. A-45).

It is correct that the Court of Appeals applied what was termed "kid-glove" treatment on some issues (Calco App. A-19). However, such deference was suggested in *Permian* (390 U.S. at 767, 791-792, 815); and in *Mobil*, this Court quoted with approval the earlier expression by the Fifth Circuit:

> " 'No one can honestly say that judges have been any more sure than commissioners, as all struggle with a problem that grows out of the peculiar mixture of a simultaneous service and exhaustion of a depletable asset. All have been groping. The day for groping is not yet over. And it does not denigrate what FPC

> has done to say that much may yet be imperfect and much remains to be done or redone. So we can find that FPC has conscientiously attempted to establish 'just and reasonable' rates within the framework allowed by judicial precedent, yet, it is still experimenting' " (*Mobil, supra*, 417 U.S. at 331).

No party, including Mobil, could assert that perfection, however perceived, has been reached in this case. The Commission frankly states that elements of a national rate structure will be reexamined in its biennial review of such rates (Calco App. C-112 - C-114; D-52 - D-56, D-63). The Court of Appeals similarly recognized that its review ". . . must be tailored to the practical requirements of the circumstances," and the burdens of procedural and evidentiary requirements must not be such that they ". . . would either prolong or complicate the task of the Commission to the point of impossibility." (Calco App. A-23).

Principles stated in *Permian* and *Mobil* thus were apprehended properly; standards of Section 19(b) of the Act were applied properly; and the decision of the Court of Appeals raises no questions requiring intervention of this Court.

II. The Court of Appeals Committed No Error In Affirming The Commission Decision To Allow The New National Rate For Sales Under New Contracts Replacing Expired Contracts

Petitioners in Nos. 75-1304, 75-1305, and 75-1308 seek review of the affirmance of the Commission's decision to allow the new national rate for sales under new contracts filed to replace long-term contracts which have expired or expire by their own terms (APGA Pet., p. 3; NYPSC Pet., p. 3; AGD Pet., p. 2). None of the petitions reflects reasons for review by this Court:

1. Petitioners' criticisms are (1) disagreement with the Court of Appeals' holding that the Commission's

decision is supported by the record and substantial evidence (APGA Pet., pp. 11, 15-16; NYPSC Pet., pp. 15-22; AGD Pet., pp. 8, 10-11); (2) assertions that the Commission decision is lacking in rational consideration (APGA Pet., pp. 14, 16); NYPSC Pet., pp. 18-19; AGD Pet., pp. 6, 8, 11, 13); or (3) arguments that the Commission should have solved the problem addressed with alternatives more acceptable to these particular petitioners (APGA Pet., pp. 15-16; NYPSC Pet., pp. 22-23; AGD Pet., pp. 9-11).

However, each of these arguments was considered fully by the court below; criteria stated in *Permian* and *Mobil* were applied; and the Court of Appeals correctly concluded:

> "The FPC has reached a well-considered, expert decision on this issue. The Commission found from evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds." (Calco App. A-29).
>
> * * * *
>
> "Under such a circumstance, no party has carried the heavy burden of showing that the Commission's balance is tilted so far in either direction as to be unjust and unreasonable in its consequence." (Calco App. A-30).

2. The Commission decision corrected an anomalous situation existent under the two-tier pricing system initiated in 1960 and is rationally supported.

Under the area-rate system, two separate ceiling rates were prescribed for "flowing" gas and "new" gas, depending upon date of contract. When a long-term contract covering "flowing" gas expired, the producer had the options of (1) seeking "abandonment" of the sale under Section 7(b) of the Act and a new contract with an interstate or intrastate buyer; or (2) continuing the sale,

filing a unilateral rate increase to the level selected by the producer, and collecting such increased rate subject to refund pending hearings and decisions on reasonableness. See *United Gas Pipe Line Co.* v. *FPC*, 385 U.S. 83 (1966); *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137 (1960).

In 1972, the Commission reviewed this situation, the original Commission intent to phase out the "two-price" "vintaging" system, and the need to encourage prompt negotiation of replacement contracts. In its Opinion No. 639, the Commission thus concluded that when the producer and pipeline negotiated a new contract to replace a contract expiring by its own terms, deliveries under the new contract would be eligible for the "new" gas ceiling rate. *Area Rate for Appalachian and Illinois Basin Areas*, 48 FPC 1299, *reh. den.* 49 FPC 361 (1973), aff'd *sub nom Shell Oil Company*, 491 F.2d 82 (5th Cir. 1974).

In this case, the Commission reexamined this policy (Calco App. C-107). The Commission concluded *inter alia*, that sales under "replacement" contracts should be eligible for the new national rate to provide additional revenues for expanded exploration and development and additional dedications to the interstate market (Calco App. C-108 - C-109); a new contract negotiated by and acceptable to the purchaser was a necessary prerequisite to such eligibility (Calco App. D-43, D-45); the Commission thereby sought to assure additional commitments by the producer "in the form of additional acreage dedication, exploration and development activity on the previously dedicated acreage, or other similar activities that could result in the dedication of additional new gas supplies to the interstate market" (Calco App. D-45); and where such new contracts were negotiated, the additional revenues would provide "capital available to those entities which will explore for and develop new natural gas supplies for the interstate market" (Calco App. D-5).

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The Court of Appeals' opinion reflects that these conclusions were not reached, as petitioners assert, in isolation and without reference to the extensive record. Thus, the record reflects that all parties had adequate notice and opportunity to be heard on the issue (Calco App. A-27); certain of the cost data before the Commission included then current costs of recompletions, deeper drilling, and "rejuvenating old wells to extend their productive life" (Calco App. A-10), and capital costs of recompletions (Calco App. A-11); the Commission was applying the rate "functionally" (Calco App. A-29); and the Commission had exercised its "discretion after considering all pertinent options" (Calco App. A-30).[6]

Contentions that the court below failed to canvass the record and apply proper standards of review thus are without foundation. The Commission's conclusions were supported and rationally considered, as the court held. Petitioners, in essence, simply seek to substitute their judgment for the reasoned conclusions of the Commission on questions of rate design and policy—questions which Congress entrusted to the Commission, as recognized in *Permian* and in *Mobil*.[7]

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[6] Commission use of a "functional" approach in rate design, to encourage exploration and development, was sanctioned in *Permian* (390 U.S. at 796-798) and again in *Mobil* over objections by New York strikingly similar to those now asserted here (417 U.S. at 319-321). The language of this Court in *Mobil* was similar to that of the court below in its reference to Commission rate design: "From these facts it reasoned that the national rate structure should be functionally applied to provide some of these funds, placing the burden not just on 'new' gas but also on flowing gas for which the primary contract had expired" (Calco App. A-30).

[7] A consistent fallacy in petitioners' arguments on the merits is their basic thesis that "costs" associated with "flowing gas" do not change, or are immune from inflation and rising costs. Yet, even "area rates" prescribed in the 1960s were based on cost components that are not frozen and which increase over time and declining lives of fields and reservoirs. See tabulations of cost components in *Permian Basin Area Rate Proceedings*, 34 FPC 159, 220 (1965);

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3. Petitioners contend that this component of the Commission's rate design will have a dire impact on consumers, ignored by the Commission (APGA Pet., p. 15; NYPSC Pet., pp. 13, 15, 23; AGD Pet., pp. 12-13); but, again, the decisions below refute the inflated figures and exhortations.

First, as the Court of Appeals recognized, the Commission intends to evaluate, in its biennial review of the national rate structure, whether pipelines are negotiating in good faith and whether additional funds generated are reflected in monies committed to exploration and development and volumes of new supplies (Calco App. A-30). Petitioners thus not only seek to second-guess the Commission, but also imply that the Commission cannot be trusted to do what it plainly says it will do, a proposition correctly rejected by the Court of Appeals.

Secondly, petitioners' inflated numbers run afoul of the Commission's conclusion that ". . . today's consumers should share the burden of finding replacement supplies for the supplies which are being exhausted by the consumers" (Calco App. A-30). Petitioners overlook the obvious facts that any impact of the Commission's decision over the next three to five years is dependent upon (1) how many expired contracts pipelines are willing to replace, and (2) subsequent rate orders of the Commission. Moreover, petitioners' numbers, even if valid, can be assessed only in terms of national annual sales volumes exceeding multiples of trillions of cubic feet and required annual reserve additions also exceeding multiples of trillions of cubic feet (Calco App. C-19 - C-28), annual curtailments in multiples of billions of cubic feet (Calco App. C-37 - C-40), and annual capital requirements that can

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Southern Louisiana Area Rate Proceedings, 40 FPC 530, 603 (1968); *Hugoton-Anadarko Area Rate Proceedings*, 44 FPC 761, 937 (1970).

be expressed only in billions of dollars (Calco App. D-55).

Lastly, petitioners' implications that the Commission did not consider impact of the decision as to replacement contracts is not in accord with the record. The Commission did make a study of projected, potential impact of the overall national rate structure (Calco App. D-56). That study was based on assumptions that *included* supplies to be sold under renegotiated contracts (Calco App. D-57). For all gas eligible for the new rate, including such supplies, the Commission estimated increases in the average residential price ranging from 0.71 per cent to 1.46 per cent in the first year, and after five years, ranging between 4.03 per cent and 16.46 per cent, under a variety of alternative assumptions (Calco App. D-59). The Commission also assessed impact of curtailments on residential, commercial, and industrial consumers, and the higher costs of alternative fuels, concluding:

> "In evaluating the overall public interest, we must consider the benefits to the consumer of an incremental supply of gas to provide reliable gas service compared to the consumer detriment if natural gas supply is reduced. The increased consumer cost attributable to higher well-head gas prices is more than counter-balanced by the more probable assurance of continued service" (Calco App. D-60).

4. The decision of the Commission to allow the national rate for replacement contracts thus was reached after "reasoned consideration" of factors cited by petitioners. Affirmance by the Court of Appeals was in full accord with the record, decisions of this Court, and the functions of the Court of Appeals on questions of substantial evidence under Section 19(b) of the Act.

This question does not require or warrant review by this Court.

III. The Decision As To Refund Credits and Contingent Escalations Under Area Rate Orders Does Not Conflict With Constructions of The Natural Gas Act By This Court

Petitioners in Nos. 75-1289 and 75-1299 contend that this case presents questions of improper "retroactive rate-making" by the Commission (Calco Pet., pp. 2-3, 5-8; Shell Pet., pp. 3, 11-15). No such questions are presented.

In four area rate decisions, the Commission adopted integrated rate structures. These structures combined rate levels, contingent escalations, formulae under which individual producers could dedicate new supplies to work off refund liabilities incurred by collection of excess amounts during the 1960s and early 1970s, and related moratoria on other rate increases.[8]

The Commission and the courts recognized that the refund-forgiveness schemes accorded preference to producers who had collected the highest rates in the past and discriminated against producers who had made refunds and collected lower rates. See *Mobil Oil Corporation* v. *FPC*, 417 U.S. 283, 321-325 (1974). Even though these benefits were "icing" on the "cake" for the beneficiaries, the Court of Appeals and this Court nevertheless concluded that the recognized inequities were not the "degree of discrimination" which would make the schemes unlawful under the standards of Section 4 of the Act (*Mobil*, 417 U.S. at 324-325).

The Commission opinions in this case left these structures intact. The Commission affords the beneficiaries who still owe refunds the option of continuing to earn credits under the refund-forgiveness formulae, or of electing to receive the new national rate for specific sales and waiving additional credits for such sales under the refund and contingent escalation formulae (Calco App.

[8] See cases cited in fn. 4, *supra* p. 8.

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C-1, C-109 - C-110, D-64 - D-65). The Commission concluded that such treatment was "equitable," consistent with the "spirit of the area rate" decisions, and prevented "a double benefit" for the beneficiaries of those decisions (Calco App. C-110). Thus, each producer must weigh the comparative benefits individually and then choose to continue to earn the refund credits and escalations, or choose to obtain the higher national rate and waive such credits and escalations (Calco App. D-64 - D-65).

On review, the producers who apparently still owe refunds contended that such treatment constituted "improper retroactive modification" of the area rate decisions (Calco App. A-42). The Court of Appeals disagreed, holding that there was no such modification; the national rate rested upon "an independent determination of incentives"; and replacing one structure, or "providing a new alternative rate system, is an exercise of Commission discretion which does not amount to retroactive rate regulation" (Calco App. A-142).

The holding is correct and not in conflict with this Court's construction of the Natural Gas Act. Certainly, retroactive change of final rate orders is not permitted under this statute,[9] but the Commission has not violated that prohibition. The individual producer decides which of the alternative rate structures is most profitable to that producer; the option of continuing to receive all of the benefits and "iced cake" of the area rate decisions remains available; and the option of receiving the national rate is provided.

What the Commission has done thus simply is to decline to spread even more icing upon the "iced cake." The refund formulae were affirmed as a valid exercise of

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[9] See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 618 (1944); *FPC* v. *Sunray DX Oil Co.*, 391 U.S. 9, 24 (1968); *Montana-Dakota Utilities Co.* v. *Public Service Co.*, 341 U.S. 246, 254 (1951).

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Commission discretion in design of a rate structure (*Mobil*, 417 U.S. at 324-326), and so too is the Commission's decision to continue that structure as an available option for those producers who still owe refunds for excess collections in the 1960s and early 1970s.[10]

Questions as to "retroactive ratemaking" therefore are not raised in this case, and there is no conflict with this Court's decisions.

CONCLUSION

For the foregoing reasons, the petitions should be denied.

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April 9, 1976

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[10] To paraphrase this Court's observations in *Mobil*, certain producers voluntarily charged the higher rates in the 1960s and 1970s; voluntarily exercised a "business judgment" in declining to settle, reduce rates, and make refunds in those past years; and voluntarily entered into a later settlement, now embodied in the area rate decisions, to work off those refund liabilities. Now, the Commission permits further voluntary exercise of the same "business judgment": if the refund credit formulae still are more profitable, a producer can continue to receive the credits and benefits, but if the "business judgment" is that the national rate is more beneficial, the producer may elect to charge that rate and cease earning the credits (*cf. Mobil*, 417 U.S. at 324-325, 327).

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In the Supreme Court of the United States

OCTOBER TERM, 1975

NOS. 75-1289, 75-1299,
75-1304, 75-1305,
75-1308, and 75-1474

THE CALIFORNIA COMPANY, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

QUESTIONS PRESENTED

1. Whether the rulemaking procedures followed by the Federal Power Commission in establishing a nationwide ceiling rate for new sales of natural gas satisfied the requirements of the Natural Gas Act and the Administrative Procedure Act.

2. Whether the court of appeals applied the correct standard of review in affirming the Federal Power Commission's orders.

3. Whether the Federal Power Commission properly determined that the national rate may be applied to ongoing sales of natural gas if the original contract

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expires of its own terms, a renewal contract is executed, and one of those events occurs on or after January 1, 1973.

4. Whether the Federal Power Commission correctly determined that natural gas sold at the national rate could not be used to discharge refund obligations or trigger contingent escalations under the incentive provisions of prior area rate orders.

5. Whether the cost methodology employed by the Federal Power Commission is reasonable and supported by substantial evidence.

STATEMENT

1. On April 11, 1973, the Federal Power Commission commenced by public notice a rulemaking proceeding to establish the maximum just and reasonable rates for jurisdictional sales of natural gas on a nationwide basis (38 Fed. Reg. 10014). The single uniform rate was to apply to all jurisdictional sales of natural gas produced from wells commenced on or after January 1, 1973. The notice made all large producers respondents to the ratemaking proceeding, provided for the submission of sworn written comments from all interested parties as well as the named respondents, and was accompanied by a staff study on the estimated nationwide cost of finding and producing new natural gas supplies. In the notice, the Commission did not propose any specific rate, terms, or conditions and stated that it would rely instead upon the information contained in the responses submitted by the various parties and the staff study.[1]

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[1]On March 21, 1974, the original notice of rulemaking was supplemented by the issuance of a revised notice in which staff cost estimates were updated to reflect 1972 data concerning drilling costs and reserve additions (39 Fed. Reg. 11310). The study indicated that the American Gas Association (AGA) reserve additions

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Following the receipt of extensive initial and reply comments and evidentiary presentations, the Commission, on June 21, 1974, issued Opinion No. 699 (Pet. App. C), establishing a new national rate structure for producer sales that was designed to alleviate the increasingly critical gas supply shortage while maintaining reasonable prices (*id.* at C120). The salient features of the rate structure were:

1. A base rate of 42.0¢ per Mcf (with annual escalations of 1.0¢ per Mcf) subject to various adjustments.

2. A biennial review to prescribe prospective just and reasonable rates for those sales that qualify for the national rate.

3. Provisions for special relief from the national rate.

The base rate would apply to three classes of sales:

1. Sales made from wells commenced on or after January 1, 1973.

2. Sales made pursuant to a contract executed on or after January 1, 1973, for the sale of gas in interstate commerce, if the gas has not previously been sold in interstate commerce except under short-term or emergency sales procedures of the Commission's regulations.

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for 1971 and 1972 might have been understated by approximately 1.7 trillion cubic feet. Since the AGA data had played an important role in the Commission's cost analysis, comments were invited concerning this apparent disparity. A public conference was held, and the AGA was unable to refute the staff's finding. The Commission's cost analysis therefore included the finding that "the reserve additions as reported by the AGA for 1971 and 1972 are understated by approximately 1.7 Tcf" (Pet. App. C55-C56).

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> 3. Sales made pursuant to a renewal contract, if the sales were formerly made pursuant to a permanent certificate of unlimited duration under a contract that expired by its own terms, and if either the renewal contract was executed or the original contract expired on or after January 1, 1973.[2]

As part of the total rate structure the Commission also determined that natural gas sold at the new national rate could not be used to discharge refund obligations or to trigger contingent escalations under the incentive provisions of its orders in four prior area rate proceedings (Pet. App. C109-C111). Rather, producers who elect to discharge their existing refund obligations or who desire to obtain the contingent escalations for flowing gas under these prior area rate orders will be required to price the flowing gas at the rate established in the area rate orders. The Commission found this treatment "equitable since the rates established in those opinions were determined to be sufficient to encourage exploration and development activities when coupled with the [incentives]" (*id.* at C110). It stated that "[t]o allow producers to collect the [national] rate * * * and to discharge their existing obligations * * * with the same supplies of natural gas would be contrary to the spirit of the applicable area rate opinion" and would allow

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[2]This statement of the third sales category, the so-called "renewal contract" provision, encompasses later amendments to the original order. As originally stated, the category was limited to renewal contracts executed on or after January 1, 1973, which replaced contracts expiring on or after that date. The provision was later amended to include renewal contracts executed on or after January 1, 1973, even if the primary contract expired prior to that date (Opinion No. 699-A). The provision was amended further to include renewal contracts executed prior to Janaury 1, 1973, to replace primary contracts expired or expiring on or after that date (Pet. App. D43-D45).

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producers to "receive a double benefit from the rate structure which we establish in this decision" (*ibid.*).

Subsequently, in Opinion No. 699-H, the Commission increased the rate ceiling for "new gas" sales from 43.0¢ to 50.0¢ per Mcf, following a supplemental cost analysis "to assure that the rate allowed for new gas supplies adequately reflects the true cost of those supplies" (Pet. App. D15).

2. On petitions for review, the court of appeals affirmed the Commission's orders (Pet. App. A). The court ruled that the Commission could properly establish a national rate for new sales of gas by rulemaking without "adversarial trial procedures such as formal evidentiary hearings, oral testimony, and oral cross-examination" (*id.* at A23). "The procedures used in setting the national rate neither prejudiced [the participants], nor prevented a full and true disclosure of the facts" (*id.* at A25). In "an undertaking so massive and novel as setting a national rate for new gas, the proceeding would have taken years, and the Commission's power to effectively regulate the industry would have been destroyed," if the Commission had "allowed all interested parties to submit oral testimony and conduct oral cross-examination" (*id.* at A26-27).

The court also rejected each of the other attacks on the order that are reiterated in the present petitions:

(a) The Commission's cost methodology was attacked from both sides, some parties claiming that it led to a national rate for new gas that was inadequate to generate capital for future exploration and others contending that the resulting rate was too high. The court of appeals, however, approved the Commission's cost-based methodology and concluded that the national rate

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was within the zone of reasonableness accorded by reviewing courts to Commission action (*id.* at A31-A41).[3]

(b) The court also sustained the application of the new national rate to certain renewal contracts replacing old contracts for flowing gas. The court held (*id.* at A28-A30) that the Commission could properly make the rate for flowing gas bear part of the cost burden of financing added exploration. "The Commission found from evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds" (*id.* at A29). The court therefore upheld the Commission's determination "that the national rate structure should be functionally applied to provide some of these funds, placing the burden not just on 'new' gas but also on flowing gas for which the primary contract had expired" (*id.* at A30).

(c) Finally, the court of appeals sustained the Commission's determination that natural gas sold at the national rate could not be used to discharge refund obligations or to trigger contingent escalations (*id.* at A41-A42). The court held that this feature of the new national rate did not constitute "an improper retro-

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[3]The Commission's cost analysis was based upon the methodology developed in the first *Permian Basin Area Rate Proceeding*, 34 F.P.C. 159. The Commission found that the record evidence supported a range of reasonable costs, and it selected a rate within the range of rates supported by those costs that "will provide the incentive necessary to encourage producers to undertake expanded exploration and development programs and to dedicate the natural gas discovered and produced as a result of those programs to the interstate market" (Pet. App. C120). In a departure from the *Permian* methodology, the Commission also employed a discounted cash-flow model in evaluating its cost findings "to assure that the rate allowed for new gas supplies adequately reflects the true cost of those supplies" (Pet. App. D15).

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active modification of prior rate opinions" (*id.* at A42). "The new national rate is the product of an independent determination of incentives, and, as it is in so many other regards, the new rate structure is not tied to previous determinations. Replacing one incentive structure with another or, viewed in another light, providing a new alternative rate system, is an exercise of Commission discretion which does not amount to retroactive rate regulation" (*ibid.*).

ARGUMENT

The contentions raised in the petitions were carefully reviewed and correctly rejected by the court of appeals; further review by this Court is not warranted.

1. Petitioner American Public Gas Association (APGA) (Pet. No. 75-1304, pp. 6-11) contends that the Commission's use of a rulemaking process to establish the national rate violated both the Natural Gas Act and the Administrative Procedure Act. APGA argues that the Commission erred in failing to follow in these rate proceedings the formal hearing procedures of 5 U.S.C. 556 and 557. But those procedures—requiring a full evidentiary hearing before a hearing officer, an initial decision, and review by the Commission—are required for rulemaking only "[w]hen rules are required by statute to be made on the record after opportunity for an agency hearing" (5 U.S.C. 553(c)). Therefore, "Sections 556 and 557 need be applied 'only where the agency statute, in addition to providing a hearing, prescribes explicitly that it be 'on the record'" *United States* v. *Allegheny-Ludlum Steel Corp.*, 406 U.S. 742, 757. This principle applies to agency ratemaking. *United States* v. *Florida East Coast Railway Co.*, 410 U.S. 224. Since neither the ratemaking provisions of the Natural

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Gas Act (15 U.S.C. 717c, 717d) nor the rulemaking provision (15 U.S.C. 717o) requires a hearing "on the record," the formal hearing procedures of the Administrative Procedure Act are not required in the Commission's ratemaking.

APGA contends, however, that the provision in 15 U.S.C. 717r(b), making the Commission's findings conclusive if supported by substantial evidence, is the equivalent of an "on the record" requirement (Pet. No. 75-1304, p. 7). Concededly the precise words "on the record" are "not words of art, and * * *other statutory language having the same meaning could trigger the provisions of §§556 and 557 in ratemaking proceedings" *(Florida East Coast Railway Co., supra,* 410 U.S. at 238). But the three courts of appeals that have addressed the issue, including the court of appeals in this case, have uniformly concluded that neither the express provisions of the Natural Gas Act nor their legislative history requires a formal evidentiary hearing in Federal Power Commission ratemaking proceedings. *Mobil Oil Corp.* v. *Federal Power Commission,* 483 F.2d 1238 (C.A. D.C.); *American Public Gas Association* v. *Federal Power Commission,* 498 F.2d 718 (C.A. D.C.); *Phillips Petroleum Co.* v. *Federal Power Commission,* 475 F.2d 842 (C.A. 10), certiorari denied *sub nom. Chevron Oil Co.* v. *Federal Power Commission,* 414 U.S. 1146.

In any event, the words "substantial evidence" as used in 15 U.S.C. 717r(b) add nothing to the "after a hearing" language of 15 U.S.C. 717d(a), which by itself is insufficient to trigger the formal hearing requirements. *Allegheny Ludlum Steel Corp., supra.* When viewed in light of 15 U.S.C. 717n(b), which states that "[n]o informality in any hearing, investigation, or proceeding or in the manner of taking testimony shall invalidate any order, decision, rule, or regulation," the language

of 15 U.S.C. 717r(b) does not amount to an "on the record" requirement that would invoke the formal procedures of 5 U.S.C. 556 and 557.[4]

Finally, the decision below does not conflict with the District of Columbia Circuit's decision in *Mobil Oil Corp.* v. *Federal Power Commission, supra.* In *Mobil* the court held that, although a formal evidentiary hearing is not required for ratemaking, the less rigorous informal rulemaking standards of 5 U.S.C. 553 were insufficient. The court below, however, found that it was "unnecessary to enter the colloquy" between the *Mobil* court and other courts concerning the minimum procedures required for ratemaking, because the procedures followed by the Commission "went beyond the rudiments of informal rulemaking"(Pet. App. A23, A24).[5] Indeed, the court concluded that the procedures followed by the Commission

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[4]Even when a statute requires that the rulemaking procedure take place "on the record after opportunity for an agency hearing," thus making Section 556 applicable, subsection (d) of that section provides that the agency may proceed by the submission of all or part of the evidence in written form if a party will not be "prejudiced thereby." As the court below correctly held (Pet. App. A25), "[t]he procedures used in setting the national rate neither prejudiced the APGA, nor prevented a full and true disclosure of the facts."

[5]The promulgation of the national rate was preceded by a notice which "clearly indicated that the Commission intended to establish by rule nationwide rates for natural gas " (Pet. App. A23) and "provided for the submission of sworn written comments" (*id.* at A24). More than 80 parties "representing a broad range of consumer and gas industry interests" submitted "sworn testimony and evidentiary data" and were given the opportunity on a second round of submittals to "rebut both Commission and privately-generated evidence" (*ibid.*). Additionally, the Commission held a public conference on the issues concerning possible under-reporting of reserve additions and drilling footages and held two days of oral argument on its proposed orders (*ibid.*; see n. 1, pp. 2-3, *supra.*

"satisfie[d] even the more stringent requirements of the formal hearing process" (*id.* at A25). Thus, the question of what minimum procedures are necessary for ratemaking by rulemaking under the Natural Gas Act and the Administrative Procedure Act—the question before the District of Columbia Circuit in *Mobil*—is not present in this case.[6]

2. Petitioners Associated Gas Distributors (Pet. No. 75-1308, pp. 6-12) and American Public Gas Association (Pet. No. 75-1304, pp. 11-14) contend that the court of appeals applied an incorrect standard in reviewing the Commission's orders. There is no merit to the contention.

In *Permian Basin Area Rate Cases*, 390 U.S. 747, 791-792, this Court held that the responsibilities of a reviewing court were to determine (1) whether the Commission had abused or exceeded its authority; (2) whether each of the order's essential elements is supported by substantial evidence; and (3) whether the order may be expected to "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." Further, the "court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself

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[6]APGA is incorrect in suggesting that Section 1.20(g) of the Commission's regulations, 18 C.F.R. 1.20(g), requires a formal evidentiary hearing (Pet. No. 75-1304, p. 10). Section 1.20(g) governs the "presentation by the parties" when, and if, the Commission determines that a formal hearing is necessary and when it initiates such a hearing pursuant to Section 1.20(a), 18 C.F.R. 1.20(a). Section 1.20(m), 18 C.F.R. 1.20(m), sets forth the procedures to be utilized in rulemaking. Thus, Section 1.20 merely allows the Commission to implement its broad authority to tailor procedures to the needs of particular cases and cannot properly be construed to require the Commission to hold a formal hearing.

that the Commission has given reasoned consideration to each of the pertinent factors" (*id.* at 792). The Commission's orders are, therefore, entitled to a "presumption of validity," and those who would seek to overturn the orders bear "the heavy burden" of showing that the order is "unjust and unreasonable in its consequences" (*id.* at 767).

In *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, this Court emphasized that "application of the three criteria of judicial review of Commission orders is primarily the task of the courts of appeals"; that the "responsibility to assess the record to determine whether agency findings are supported by substantial evidence" is, by virtue of Section 19(b) of the Act (15 U.S.C. 717r(b)) the function of the court of appeals; and that this Court therefore will intervene only in the "rare instance when the standard appears to have been misapprehended or grossly misapplied" (417 U.S. at 309-310).

No such "rare instance" is presented here. The court of appeals correctly apprehended and properly applied the review standards enunciated by this Court in *Permian*. The ultimate issue for the court was whether the "end result" of the order was "unjust and unreasonable," and it resolved that issue by applying the criteria established by this Court in *Permian* (Pet. App. A15-A16). The court was "guided by four elements which delimit the scope of our authority" (Pet. App. A15):

> (i) the well-known statutory "substantial evidence" standard, (ii) a judicially recognized "presumption of validity" * * *, (iii) the longstanding "total effect" test of *FPC* v. *Hope Natural Gas Co.*, 1944, 320 U.S. 591, * * * and (iv) a "zone of reasonableness" to compensate for the necessarily imprecise nature of cost determinations and the inherent difficulty of the regulatory undertaking.

The court indicated, however, that its "narrow scope of review" was further "tempered" by the experimental nature of area and national rate regulation, which calls for a "heightened deference to the Commission's expertise" (*id.* at A16-A17).

Applying the *Permian* review criteria to each element of the Commission's order, the court of appeals found that the Commission was authorized to prescribe a "national" rate for new gas sales (*id.* at A20-A23) and that each element of the national rate structure—specific cost findings and methodology—was reasonable and supported by substantial evidence (*id.* at A27-A44).[7] Petitioners argue that the court incorrectly afforded the Commission's orders too

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[7]The court below rejected several attacks upon the Commission's cost-based formula raised here by petitioners APGA (Pet. No. 75-1304, pp. 12-14) and Shell Oil Company (Pet. No. 75-1299, pp. 8-11, 15-21): (1) the court found that the Commission's analysis of the evidence leading to a future productivity (the amount of natural gas added to the non-associated gas reserves for every foot drilled) was "supported by the record" (Pet. App. A31-A35); (2) the court found that the parties who had attacked the Commission's use of a discounted cash flow methodology as a supplementary cost analysis had "failed to sustain" their "weighty burden of proof" that the use of such methodology "results in an unjust and unreasonable end result" (*id.* at A37); (3) the court also found the Commission's "policy choice" of excluding an average federal income tax component from the national rate structure, in favor of allowing individual producers to seek extraordinary relief in the form of higher rates when they could demonstrate an "actual income tax liability," was not "so unjust and unreasonable" as to require judicial intervention (*id.* at A37-A39); (4) the court found that the Commission's projections of future lease acquisition costs "are based on substantial evidence and cannot be reversed at this stage" (*id.* at A40); (5) the court additionally held that the Commission's findings regarding the level of the net liquid credit, "a cost equation component of relatively little import," were sufficiently supported by the record (*id.* at A41); and (6) the court held that the Commission did not err in using cost-based ratemaking and in refusing to consider non-cost factors created solely by market forces (*id.* at A44-A45).

limited a review. However, while the "experimental nature" of national rate regulation may have resulted in "heightened deference" to the Commission's expertise, the court below scrupulously examined each element of the Commission's order. Furthermore, this "deference" to Commission expertise in ratemaking orders was a central aspect of this Court's review in both *Permian, supra,* 390 U.S. at 767, 790-792, and *Mobil, supra,* 417 U.S. at 331. The court of appeals correctly concluded that such deference was appropriate here as well, because "national rate regulation is still experimental" (Pet. App. A17).

3. Several petitioners[8] contend that the decision to apply the new national rate to certain renewal contracts for flowing gas was not supported by the record and improperly failed to require recipients to engage in exploration and development. These arguments were correctly rejected by the court of appeals.

(a) Petitioners argue that there is no evidentiary basis to support the allowance of the national rate for sales under new contracts replacing long-term contracts that have expired by their own terms.[9] But the court below found (Pet. App. A29-A30):

> The Commission found from the evidence in the record that a massive commitment of new funds is necessary to alleviate the natural gas shortage and that internally generated sums are a necessary source of such funds. * * * From these facts it reasoned that the national rate structure should be functionally applied to provide some of these funds, placing the burden not

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[8]Public Service Commission of New York (Pet. No. 75-1305, *passim*); Associated Gas Distributors (Pet. No. 75-1308, pp. 6-14); APGA (Pet. No. 75-1304, pp. 14-16).

[9]The Commission found a gross disparity between supply and demand and explained that, if the nation's future need for natural

just on "new" gas but also on flowing gas for which the primary contract had expired.

Petitioners have not shown that the court of appeals has "misapprehended or grossly misapplied" the substantial evidence standard. *Mobil, supra,* 417 U.S. at 310. Moreover, the Commission's use of price functionally to encourage exploration and development, and specifically its determination that the burden of future exploration and development should be borne in part by consumers of flowing gas, were upheld by this Court in *Mobil, supra,* 417 U.S. at 319-321. The specific mechanism chosen by the Commission to accomplish that end in the national rate case—applying the national rate to certain renewal contracts for flowing gas—has been sanctioned by the two courts of appeals that have previously addressed the issue. *Shell Oil Co.* v. *Federal Power Commission,* 491 F.2d 82 (C.A. 5); *Public Service Commission for the State of New York* v. *Federal Power Commission,* C.A. D.C., Nos. 73-1647, *et al.,* decided January 27, 1976, pending on petitions for certiorari, Nos. 75-1556, 75-1565.

(b) Petitioners suggest that even if it is permissible to increase the rate for flowing gas, the Commission erred in not requiring the producers receiving the rate increase to engage in exploration and development. The Commission determined that imposing a specific exploration and development commitment as a condition of a rate increase in replacement contracts was not neces-

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gas was to be satisfied, massive capital commitments were necessary to expand programs of exploration and development (Pet. App. C26-C28). It found that, but for the generation of internal capital through rate relief, the essential expansion of exploration and development would not take place (*id.* at D55-D56). The Commission acknowledged the impact upon the consumer in terms of the increased price of gas supplies (*id.* at D56-D62), but it concluded that the increased consumer cost attributable to higher well-head gas prices was more than counterbalanced by the greater assurance of continued service (*id.* at D60).

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sary, believing instead "that by requiring an old contract to be renegotiated before the new rate is recoverable, the pipeline might be able to negotiate for additional acreage dedication to interstate commerce, or exploration and development activity on previously dedicated acreage or other concessions for the price increase" (Pet. App. A29). Petitioners argue that in a time of natural gas shortage the pipeline negotiating a replacement contract will not be in a position to bargain for any increased gas supplies for the interstate market. In essence, petitioners seek to substitute their judgment for that of the Commission, but they have not carried their "heavy burden of making a convincing showing that [the Commission's judgment] is invalid because it is unjust and unreasonable in its consequences." *Mobil, supra*, 417 U.S. at 307, quoting *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602. As the court below correctly concluded, "the Commission has exercised its discretion after considering all pertinent options" and has "reached a well-considered, expert decision on this issue" (Pet. App. A29).

(c) In contrast to the consumer petitioners, Superior Oil Company (Pet. No. 75-1474, pp. 8-17) argues that it was illegal and arbitrary for the Commission to require a newly executed sales contract as a condition of receiving the national rate. Superior contends that the Commission lacks the authority to compel a producer and a pipeline to enter into a contract (*id.* at 10). But the Commission has not required the execution of a contract; nor has it dictated the terms of a contract if one is entered into. Under the Commission's order, the parties remain free to contract or not to contract and to determine the terms of their service contracts. Cf. *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U.S. 348; *United Gas Pipe Line Co.* v.

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Mobile Gas Service Corp., 350 U.S. 332. The Commission has simply determined that, if a replacement contract is executed, the newly-prescribed national rate should be applicable because of the possibility that the pipeline may be able to bargain for additional acreage dedication, increased exploration and development activity, or other concessions for the rate increase. However, if the national rate were allowed with or without a new contract, a producer would be released from any obligation to bargain with a pipeline, thus eliminating any possibility of a *quid pro quo* for the rate increase.[10]

4. The Commission required producers, as a condition of receiving the national rate for "new gas," to waive their right to utilize such gas to discharge refund obligations and trigger contingent escalations under the incentive provisions of prior area rate orders. Shell Oil Company (Pet. No. 75-1299, pp. 11-15), California Company (Pet. No. 75-1289, *passim*), and Superior Oil Company (Pet. No. 75-1474, pp. 18-25) contend that this requirement is an illegal retroactive modification of prior rate orders.

However, by determining that gas sold at the national rate level cannot be used to take advantage of certain

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[10]Arguments that the requirement of a replacement contract is anticompetitive (Pet. No. 75-1474, pp. 15-17) and unduly discriminatory (*id.* at 17-18) are unfounded. There is no evidence in the record to support these assertions. Furthermore, the objections are premature. As the court below recognized, the Commission has "expressly reserved for consideration in the biennial review the question of whether the pipelines are negotiating in good faith or trying to take advantage of the producer's locked-in position, and whether or not the additional funds generated by the application of the new rate increase 'the level of monies committed to exploration and development programs and the volumes of new gas supplies dedicated to interstate pipelines under long-term contracts' " (Pet. App. A30).

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incentive provisions in prior rate orders, the Commission did not retroactively modify those orders. To the contrary, the incentive features of those orders are still operative. Each producer has a choice. He may sell his gas under the national rate structure without refund discharges and contingent escalations, or he may continue to sell at the rates prescribed in the area rate orders and avail himself of the refund discharge and contingent escalation provisions of those orders. In other words, the Commission has done nothing more than provide producers with a new alternative rate system which, as the court below correctly found, "is an exercise of Commission discretion which does not amount to retroactive rate regulation" (Pet. App. A42).[11]

Furthermore, the incentive provisions in the prior area rate orders were designed to operate in conjunction with the prescribed base *area* rate levels. As the Commission said, "the rates established in those opinions were determined to be sufficient to encourage exploration and

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[11]An identical disposition was reached by the United States Court of Appeals for the District of Columbia Circuit in *Moss* v. *Federal Power Commission*, 502 F.2d 461 (C.A. D.C.), reversed on other grounds, No. 74-883, decided March 3, 1976. The court of appeals reviewed the Commission's optional certificate procedure and upheld the provision under which a producer who obtains an optional certificate must waive his right to benefit from any contingent escalations or refund discharges that might be triggered in the area in which his sale under the optional procedure is made. The producers in that case argued, as do the petitioners here, that they were entitled to benefit from the previously established incentives *and* to sell their gas in excess of the area ceiling rate pursuant to the optional certificate procedure. The court there reasoned that in prescribing the optional procedure the Commission had provided an alternative for each producer: "[h]e may dedicate his new gas under the procedure that is most beneficial to him. * * * He may benefit under one procedure but not under both" (502 F.2d at 470). Similarly, under the orders here, a producer may sell his gas at the national rate without the incentives, or at the area rate with the incentives, but not both.

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development activities when coupled with the refund credit incentives and contingent escalations" (Pet. App. C110). To allow new dedications of gas to receive the national rate and, at the same time, discharge refund obligations or trigger contingent escalations would therefore be "an apostasy of the Commission's area rate opinions which adopted the contingent escalations and refund credits as part of a rate structure which included the then prevailing area rates for flowing gas and new gas" (Pet. App. D65).

CONCLUSION

The petitions for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1976.

DOJ-1976-05

FILED THROUGH